The Free Market

"If you don't create a free market, a black market will emerge"

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NEWS

› LFMI presented the Index of Economic Freedom for the first time in Lithuania

On January 12, 2006 the Lithuanian Free Market Institute (LFMI) staged a round table discussion "Lithuania in the 2006 Index of Economic Freedom: whom to look up to?" which took place at the Presidential Palace in Vilnius. This was the first presentation of the Index of Economic Freedom in Lithuania, released by the Heritage Foundation and the Wall Street Journal. During the event, Lithuania's President Valdas Adamkus delivered a welcome speech and Dr. Marc Miles, one of the Editors of the Index and director of the Centre for International Trade and Economics at the Heritage Foundation, presented a key presentation. Other speeches were delivered by Dr. Ramūnas Vilpišauskas, Advisor to President of Lithuania, Algė Budrytė, Deputy Chief Economist from the leading bank in Lithuania *SEB Vilnius Bank*, and Dr. Guoda Steponavičienė, Vice President, LFMI.

The discussion drew more than one hundred participants – MPs, ministers and high ministerial workers, ambassadors, business leaders and representatives from business associations, business and finance analysts, academics, students, and media representatives.

In 2005 the Heritage Foundation, a pre-eminent US-based organization, invited LFMI to be one of the seven partners in Europe to help prepare and disseminate the Index of Economic Freedom, published and announced annually with the Wall Street Journal.

In addition to this event, LFMI's President Ugnius Trumpa took part in a meeting with Prime Minister Algirdas Brazauskas, January 20, and Speaker of the Parliament Artūras Paulauskas, January 19, and presented the book with the latest study in person. A leading business daily *Verslo Žinios* published an exclusive interview with Dr. Marc Miles, January 16, about the Index and lessons for Lithuania.

Lithuania's Economic Freedom Remained at Nearly the Same Level

The goal of the LFMI's discussion was to present the results of the latest study, the 2006 Index of Economic Freedom, and to debate which countries' lead Lithuania should follow and what should be done to achieve higher ratings of economic freedom.

The 2006 study shows that economic freedom made impressive gains throughout North America and Europe in general; however, Lithuania's situation remained unimproved, while Estonia and Latvia posted sharp declines.

According to the survey, the level of economic freedom in Lithuania remained virtually unchanged: Lithuania ranks 23rd, the same as in the previous study, although the country's score slightly improved, by four tenths to 2.14. Lithuania remains in the group of "mostly free" countries. The country's overall score is higher in the current index as the figure for fiscal burden of government is better this year; however, it is still driven down by vast bureaucracies and corruption, insufficient confidence in courts and price controls.

Neighbouring countries suffered a sharp drop in economic freedom: Estonia moved from the 4th place to the 9th, but still remains among the "free" countries, and Latvia plummeted by 33 positions to 39th place. According to the authors of the study, rising government spending and the adoption of EU trade policies worsened Estonia's Index score. Latvia was pushed down by increased fiscal burden and inflation.

In general, the regions of North America and Europe saw an impressive rise in economic freedom. From the western end of the region, where the United States rejoined the world's 10 freest economies, to the middle, where Germany joined the ranks of "free" economies for the first time, to the eastern end, where Romania improved more than any other country worldwide except Pakistan, the North America-Europe region widened its worldwide lead in economic freedom.

Lithuania's President sees room for increasing economic freedom

In his welcome speech at the LFMI's discussion, Lithuania's President Valdas Adamkus rejoiced that in this year Lithuania managed to retain a high ranking at 23rd among the 157 measured countries throughout the globe. "It is a very important achievement for our country and it should encourage us to be even more persistent in ensuring increasingly better results in the coming year," - said Mr. Adamkus.

(From the right: Lithuania's President Valdas Adamkus, Dr. Remigijus Šimašius and Dr. Marc Miles)

However, Lithuania's President regretted that Lithuania remains in the group only of "mostly free" countries and has not yet entered the group of the twenty economically "free" countries. But he said he was optimistic about the prospects of the country's economic freedom in the future and enumerated several reasons for that. First, in 2005 Lithuania launched a tax reform which incorporated a reduction of the personal income tax. Second, Lithuania is pursuing a sound monetary policy and envisages its overhaul by finally adopting a methodology of programme budget formation and evaluation. Third, the business community and the government have recently started a close dialogue to find ways to increase Lithuania's competitiveness.

Mr. Valdas Adamkus expressed his strong belief that Lithuania, while adopting laws and fixing rules, had to raise a question whether these decisions would make the country more competitive. "We cannot forget that increasing competitiveness is one of three priorities for our country. Competitive, free and advancing economy is an essential condition to achieve other priority goals," - stated the President.

Optimism is being shadowed

While presenting the 12th Index of Economic Freedom, Dr. Marc Miles, a co-author of the study, said that Lithuania had real opportunities to become one of the world's "free" countries and that it was already leading other nations and setting trends for tax systems. According to the speaker, Lithuania should be proud of its low corporate profit tax rate and an ongoing reduction of the personal income tax.

Dr. Marc Miles highlighted at the discussion that creation of wealth is strongly dependant on economic freedom in the country. "A recipe for reducing poverty is clear and simple – the more economic freedom, the greater the well-being, the more economic freedom, the more rapid economic growth,"- explained the author of the research. The study shows that average income per capita is twice higher in "free" countries than in "mostly free" (Lithuania is in the group of "mostly free" countries). Countries with constricted economies are among the poorest ones.

According to the latest study, worldwide, the scores of 99 countries improved and 51 declined.

Algė Budrytė, Deputy Chief Economist from *SEB Vilnius Bank*, concluded that in terms of economic freedom, Lithuania was neither an outsider nor a winner. "The good news is that economic freedom in Lithuania has been increasing, albeit modestly, since the very launch of the index,"- she commented. Ms. Budrytė pointed that the stability of the financial sector, secured through one of Lithuania's most successful reforms over the past fifteen years, the monetary reform, had undoubtedly contributed to this achievement. She also mentioned an important fact that currently Lithuania had one of the lowest inflation rates among the EU newcomers.

However, Ms. Budrytė regretted that Lithuania still had unsolved problems which did not allow the country to break the barrier of "mostly free" countries and join the group of "free" nations. This shows that the country has much to accomplish yet. According to the analyst, economic freedom is being inhibited the most by such law-and-order-related phenomena as entrenched corruption, bureaucratic barriers to business and an insufficiently credible judiciary.

Banker Budrytė stated the Heritage Foundation's Index of Economic Freedom is quite credible and representative because analogous studies of other authoritative institutions, such as the Fraser Institute in Canada and the Harvard Institute for International Development, give very similar trends. According to her, this Index pinpoint to the existing policy "cracks" in Lithuania and forces the country's authorities to search for ways how to "cover" them.

Advisor to President Dr. Ramūnas Vilpišauskas agreed with Ms. Budrytė, as regards the credibility of the Index of Economic Freedom, and added that "such studies are useful as they help to look critically at both ourselves and others." He noted that Lithuania had made the least changes in the fields where EU's regulatory impact is minimal – the education and the health care systems and procedures of land use. In his opinion, a lack of reforms in these particular areas is a primary roadblock to enhancing Lithuania's competitiveness.

As LFMI's Vice President Dr. Guoda Steponavičienė said at the event, Lithuania could improve its results in the Index by reducing tax rates and the budget deficit. She pointed out that judging from the study there are no formal restrictions on foreign investments in Lithuania, but the statistics shows that the country manages to attract only very negligible investments. "It seems as if we were overestimated,"- she commented.

Ms. Steponavičienė highlighted that Lithuania has the poorest score in the category of "informal economy activity." However, she pointed, a reduction of the shadow economy is a long-term process related with confidence, tradition, and business and administrative culture, therefore quick improvement can hardly be attained in this area.

About the Index

Since 1995, this Index of Economic Freedom, prepared by the Heritage Foundation, an influential US-based non-government organisation, together with the Wall Street Journal, measures economic freedom in 161 countries throughout the world and analyses basic factors that determine economic growth. The Index ratings reflect an analysis of 50 different economic variables, grouped into 10 categories: banking and finance; capital flows and foreign investment; monetary policy; fiscal burden of government; trade policy; wages and prices; government intervention in the economy; property rights; regulation; and informal (or black) market activity. For 12 years the Index has been internationally acclaimed for its comprehensive, data-rich summary of prevailing economic conditions around the globe. An indispensable resource for investors, academics, and policymakers, it answers why some countries are rich, why some are poor, and why some are stagnant... The study can be found online at: www.heritage.org/index.

› LFMI presents a new website

Celebrating the 15th year of activity, the Lithuanian Free Market Institute (LFMI) presents a new website which was launched on January 16, 2006.

One of the most visible changes in LFMI's website are a new design and the introduction of a third, horizontal, menu. The third block shows four strategic areas that are currently analysed by LFMI. The rest of the topics can be found in the directory "Other areas."

The vertical menu of the new website is similar to the former one, although certain changes were made. The contents of the directories of the old version "Programmes, projects" and "Research, analysis" were moved to directories "Research" of the horizontal menu according to the topic. The former directory "Articles, papers" was renamed as "Newsroom" and expanded.

One of the innovations of LFMI's website is a tool to order LFMI's news online. Visitors interested in attending LFMI's events from now on will have a possibility to register online to LFMI's public events.

Other changes are an enhanced search system, a site map, and tools for reading and printing texts.

The old version of LFMI's website can be accessed at: http://www3.freema.org/.

LFMI hopes that visitors will find LFMI's new website more convenient and functional.

› LFMI participates in a second international project on the information society

The Lithuanian Free Market Institute (LFMI), with a group of European partners and a coordinating institution "ICEG European Centre," have won a second tender announced and financed by the Institute of Prospective Technological Studies (IPTS), one of the seven scientific institutes of the European Commission's Joint Research Centre, Seville. Its mission is to provide customer-driven support to the EU policy-making process by researching science-based responses to policy challenges that have both a socio-economic and a scientific or technological dimension.

Within the framework of this international project, 10 partner-organisations will conduct separate country-reports, and based on those, a comparative synthesis report will be prepared later by the "ICEG European Centre." Project partners are organisations from Hungary, Malta, Latvia, Lithuania, Estonia, Slovenia, the Check Republic, Slovakia, Poland and Cyprus.

The first study that will be made by the Lithuanian Free

Market Institute, a representative of Lithuania, is entitled "Next Steps in Developing Information Society Services in the New Member States: the Case of eGovernment and eHealth." The aim of this research is to collect relevant qualitative and quantitative data in the areas of eGovernment and eHealth, analyse it and develop a meaningful assessment of both areas state and trajectory of development, and derive relevant conclusions in terms of policy and research. The study will analyse the quantitative and qualitative description of the current institutional, policy framework as well as underlying trends and developments in Lithuania and focus its attention at the future policy options and R&D related challenges specific to eGovernment and eHealth. The study will clearly indicate the overlapping domains and issues common for both eGovernment and eHealth, while being specific in both topics.

The aim of the second study, called "Next Steps in Developing Information Society Services in the New Member States: the Case of eLearning," is to collect relevant qualitative and quantitative data in the field of eLearning in Lithuania, analyse it and develop a meaningful assessment of the areas state and trajectory of development, and derive relevant conclusions in terms of policy and research. In this study LFMI will look into the factors inhibiting the development of eLearning in Lithuania, identify those factors which would promote its development and formulate recommendations.

Both studies will be completed by December 2006. The life of the entire international project will be 14 months, followed at the end by an extensive dissemination campaign at the EU level.

In 2003-2004 the Lithuanian Free Market Institute participated in an international research project "Factors and Impacts in the Information Society: a Prospective Analysis in the Acceding and Candidate Countries" financed and coordinate by the same institutions. During this project, LFMI conducted a study on factors and impacts in the information society in Lithuania (**the study is posted online…**).

› The main purpose of land use is a redundant bureaucratic barrier that should be eliminated, says LFMI

Pursuing activities in the area of land market regulations, LFMI conducted research on the main purpose of land use, examining the legal framework of settling the main purpose of land use and the development thereof, the expediency of this regulatory barrier and its negative effects on market participants as well as indispensable changes. The results of the research were presented at a press conference on January 19, 2006.

The main conclusion of LFMI's research is that administrative settling of the purpose of land use is an unnecessary bureaucratic restriction inherited from the Soviet times that inhibits companies' and residents' disposal of land. LFMI is of the opinion that this redundant regulation could be easily removed and proposes to do so because its functions may well be carried out by general teritorial planning. The Institute points out that the issue of land use is usually resolved at the stage of teritorial planning, for this reason a separate procedure and a special permit are superfluous and needless.

LFMI highlighted in the research that designation of land use discourages an efficient use of limited land resources in Lithuania and builds favourable preconditions for corruption.

› LFMI carries out thorough studies on transport policy

Seeking to promote reforms in individual transport sectors, the Lithuanian Free Market Institute carried out two comprehensive studies in 2005 and presented them at a press conference and a conference "Will Lithuania's Seaport and Railways Serve the Consumer?" The event aimed at debating the prospects for, and the guidelines of, further development of the Klaipeda Seaport and the Lithuanian Railways.

LFMI's study "Reforms in the Lithuanian Railways: how and when?" draws the guidelines for structural reforms in the country's railway sector, discusses the existing problems and needed changes, and presents the ways how to solve these problems and institute changes. The study presents an overview of EU transport policy, discusses the transposition of the railway *acquis* into the Lithuanian law, speaks about the carriage of cargo and passengers, analyses the pricing and the tariff policy conducted by the state company *Lithuanian Railways* and international agreements regarding railway carriage.

LFMI concluded that Lithuania is seriously lagging behind other EU countries in liberalising the railway sector and calls Lithuanian authorities for reforming this sector without further delay. LFMI proposes the following steps in overhauling the Lithuanian railway system. First, to separate completely the track from the carrier and to create conditions for competition among the carriers, and to privatise public carriers and the approach roads after the reform. Second, to define explicitly the funding of social functions and the infrastructure from the budget. Third, to minimise the loss-making services and the services of public infrastructure net, to renovate the infrastructure by ensuring conditions to enhance quality in the remaining profitable and perspective itineraries. And fourth, Lithuania's transport policy should be formed by the Lithuanian Government and parties, not the state-run company *Lithuanian Railways*.

LFMI believes that the reform of the railway sector in Lithuania would help cracking other issues that are currently not targeted at the state level, such as the tariffs of carriage and the approach roads.

In the study "Management of the Klaipėda Seaport: Challenges, Ways and Solutions" LFMI analyses the main policy factors, responsible for the Klaipėda seaport's difficulty to compete on the international markets and to attract as many cargoes as it otherwise could, presents an in-depth analysis of problems provoked by these policy regulations, and proposes recommendations for regulation and administration of the Klaipeda Seaport. The study focuses on the main aspects of the seaport management and regulation system, land ownership and economic issues.

The central conclusion made by LFMI in this study is that privatisation of the management of the Klaipėda Seaport would increase its competitiveness and attractiveness on the market. This step would also ensure the seaport's autonomy from political pressure and maximum efficiency.

› LFMI proposes not to mix the energy policy with politics

On November 29, 2005, the Lithuanian Free Market Institute (LFMI) staged a conference "Market or Politics in the Energy Sector?" to debate the prospects of the energy policy in Lithuania. The goal of the event was to direct the ongoing discussions over the energy issues from interest-seeking to finding proper solutions which would help build a consumer-friendly and viable energy system in Lithuania.

At the conference LFMI presented a study "The Energy Policy: Measures, Possibilities and Directions" which defines and evaluates systematically the problems of the Lithuanian energy sector, presents economic arguments needed to estimate currently debated political proposals and provides recommendations regarding the course of the state's policy and solutions to the most pressing problems in the energy sector.

At the bottom of LFMI's recommendations for the energy policy lie the necessity to create conditions for competition and possibilities to deregulate this sector. If principles proposed by LFMI were fully implemented, all monopoly privileges would be eliminated, allowing the energy prices to fall where possible. The implementation of LFMI's principles would allow maintaining an ultimately low general price level, without inflicting upon the viability of the energy sector and the security of the consumer-preferred energy supply. LFMI's proposal would help open up new opportunities in those areas where energy prices are artificially reduced today, allowing using the energy resources most efficiently, while social issues would be tackled more expediently than they are today.

The energy policy is one of the strategic fields of LFMI's activity in 2005-2007. This study was also submitted to relevant official institutions and business associations.

Dr. Remigijus Šimašius will participate in drafting a national energy strategy

In December 2005 LFMI's Vice President Dr. Remigijus Šimašius was invited by the Lithuanian Ministry of Economy to take part in a renewed commission to draft a national energy strategy. Headed by the Ministry's Vice Minister Nerijus Eidukevičius, the commission consists of 20 members – ministerial workers, academics and scientists specializing in the energy issues, representatives from the energy companies and supervisory institutions. The draft of the strategy is planned to be ready until April 15, 2006.

› Economic growth has reached people's pockets but may start declining, shows LFMI's survey

In November 2005, the Lithuanian Free Market Institute (LFMI) released the results of the 16th survey of the Lithuanian Economy, presenting forecasts for 2005 (updated) and 2006.

According to market participants polled by LFMI in August to September 2005, the economy in Lithuania will continue to grow both steadily and rapidly in 2005 and 2006. Economic indicators, although noticeably worse than a couple of years ago, remain rather high and economic growth seems to have finally reached the general population – both monthly income and household income are on the increase, people save, invest and spend much more than in the previous years.

However, there is reason to believe that the country's economy may start loosing momentum as no firm foundations to bolster further and long-term growth are being created. The Lithuanian government is not pursuing a migration policy whatsoever, the education system remains unreformed and there is no political will to cut tax rates significantly and to conduct a strict budget policy.

The LFMI survey shows that the growth of income is being stimulated by both fierce competition in the labour market and an improving economic situation. Bigger monthly salaries, together with the money that Lithuanians working abroad send back to their families, contribute to improving financial situation of Lithuanian households.

The financial situation of businesses is also improving, while the rate of unemployment is still on a continuous decline. Economic growth is being further bolstered by an expanding internal market and the removal of the last barriers to trade which, together with improved export conditions, prompted rapid export growth after EU accession; brighter expectations of both companies and people, leading to increased consumer consumption, also contribute to growth.

On a more pessimistic note, it should be pointed out that the level of the shadow economy is not falling – on the contrary, it is on the rise, and the same goes for the tax burden. The optimism over steadily decreasing unemployment is shadowed by a wave of emigration and a non-existent immigration policy as well as a high level of structural unemployment and a lack of the qualified labour force.

Overall, after joining the EU fewer leaps in the forecasts of market participants have occurred in the survey - their estimates have been much steadier since then. Market participants hope for steady employment, continuous growth of income, investments and foreign trade, but do not project any big changes caused by external factors.

A full summary of the results of the 16th survey of the Lithuanian economy can be found online (**click here…**).

About the survey

Launched in 1997, the LFMI survey is aimed to provide estimates and forecasts of economic variables in Lithuania based on the opinion of market participants, to analyse factors that influence the outlooks of market participants, to compare the survey results with official statistics and data from other sources, and to offer interpretations of the most distinct differences.

The LFMI survey is based on the expert consensus paradigm originating from the theory of rational expectations. This theory states that, if a connection exists between an economic variable and certain processes in the economy, market participants will use all available information to make estimates and forecasts.

Forty-eight respondents participated in this survey. The survey was funded by “Ergo Lietuva gyvybės draudimas,“ “Kappa Packaging Baltic,“ “Ragutis,“ “Santa Monika Networks,“ Ūkio bankas and “VST.“

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SPEECH

The following paper was presented by Algė Budrytė, Chief Analyst from SEB Vilnius Bank, at a round table discussion “Lithuania in the 2006 Index of Economic Freedom: whom to look up to?” staged by the Lithuanian Free Market Institute on January 12, 2006.

The 2006 Index of Economic Freedom: Whom to Look up to?

By Algė Budrytė, Deputy Chief Economist, SEB Vilniaus Bankas, Lithuania

Let me sincerely thank the hosts of this event for their attention and for the opportunity to participate in this discussion. My comments on the research findings will focus on two main aspects. First, let me share my thoughts about the implications of economic freedom for business growth prospects and economic development in general. Second, I will try to answer the question what Lithuania can learn from the 2006 economic freedom index.

A hundred years ago one could hardly imagine the amazing technological progress made over the past century or today’s scope of globalization or meteoric speed rates of information flows. So it can be assumed that the “dissolving borders” among the world’s economies have reduced the gap between the richest and the poorest countries. Unfortunately, actual figures point to the contrary trends. According to the World Bank, in the 1870s the average income per capita in the 17 wealthiest nations was 2.4 times higher than that in the rest of the world, and in the 1990s this gap widened to 4.5 times. Why has the gap been widening?

Back at the end of the 18th century one of the most prominent founders of modern economic science, Scottish scientist Adam Smith attributed England’s economic achievements to its geographic location. Today’s empirical studies confirm Smith’s arguments. In analysing the patterns of global development from 1965 through 1990, economists at the Harvard Institute for International Development have found that being entirely landlocked can trim down a country’s economic growth rate by about 0.7 percentage point. A severe climate, demographic trends, culture and twists in history are other major factors explaining the widening gap between the rich and the poor.

Given all these “natural” disadvantages, it would appear that many African nations are doomed to poverty: after all, we cannot „present” them with the seaside or alter the tropical climate, which is not good for agriculture but quite favourable for the spread of terminal diseases and epidemics. Fortunately, the situation is not hopeless. As Nobel prize-winner Milton Friedman noted more than twenty years ago, the cure for economic deprivation is economic freedom. Economic literature offers ample evidence of this proposition. There is no doubt that the research findings being presented today are one piece of evidence.

According to the twelfth edition of the economic freedom index, GDP per capita, measured by purchasing power parity, in Hong Kong, which enjoys the highest rating of economic freedom, was not the highest in 2004. On the other hand, analysis of all of the countries covered by in the index indicates a positive long-term correlation between economic freedom and living standards. As the authors of the index note, the countries which belong to the „repressed” and „mostly unfree” groups have 70 percent lower income per capita than „mostly free” nations, including Lithuania. Unfortunately, the latter group falls behind „free” countries more than twice. It should be noted that the credibility of these findings is high as research performed by other well-known institutions, e.g. Canada’s’ Fraser Institute or the Harvard Institute for International Development, show very similar results.

Analysts at the Heritage Foundation and *The Wall Street Journal* define economic freedom as the absence of government coercion or constraint on the production, distribution or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself. In other words, economic freedom can be broadly understood as every one of us being free to use our legitimate property to the extent that we do not inhibit other people’s possibilities to do the same. Goods and services do not appear out of a blue sky. Their existence depends on the guarantees of ownership rights and motivations to produce, to distribute and to consume them. So the level of economic freedom in a given country depends essentially on the policies and the institutional environment that this country has pursued. That is to say, the scope of economic freedom depends on how well a country is doing in legitimate protection and establishment of ownership rights, how much people are suffering from trade restrictions, how much inflation trims their purchasing power, and many other factors.

In this respect and in comparison with economic freedom indicators from other sources, one of the major advantages of the index under discussion today is its representative character. The 2006 Index of Economic Freedom measures 157 countries against a list of 50 independent variables divided into ten factors of economic freedom. An analogous index from the Fraser Institute ranks slightly more than 120 nations against five factors of economic freedom based on 38 variables. On the other hand, the Fraser Institute’s index dates back to 1970, whereas the Heritage Foundation and *The Wall Street Journal‘s* index was started only in 1995.

At first sight, qualitative methodology of the Heritage Foundation and *The Wall Street Journal's* index appears to be another disadvantage – although in the initial stage an analysis is performed on the basis of quantitative statistical indicators, a country's overall economic freedom rating is an average score granted by experts. In addition, all ten factors of economic freedom are weighted equally: it is assumed that all of them are equally important in any country.

On the other hand, these can hardly be considered serious drawbacks of this kind of surveys. The authors of the index do not aim to measure quantitatively the effect that each of the factors of economic freedom has for a country's economic development but rather are seeking to determine the degree to which a country is economically free. Furthermore, the application of the same methodology in all countries is a prerequisite for a proper comparison.

In terms of economic freedom, Lithuania is neither an outsider nor a winner. The good news is that economic freedom in Lithuania has been increasing since the very launch of the index. As the latest data show, Lithuania has managed to retain the same ranking, while both of our Baltic neighbours have gone down, i.e. they have faced tighter constraints on economic freedom.

As a representative of the financial sector, I find it particularly delightful that the situation in Lithuania's banking sector has merited the highest score for some time now. The stability of the financial sector, which has been secured through one of Lithuania's most successful reforms over the past fifteen years, the monetary reform, has undoubtedly contributed to this achievement. Furthermore, it is important mentioning that currently Lithuania has one of the lowest inflation rates among the EU newcomers.

According to the Harvard Institute for International Development, the most important economic policy areas for achieving economic well-being are openness of an economy, prudent fiscal discipline and credible rule of law. The annual growth rate of open economies is by approximately 1.2 percentage point higher than that of countries barricaded with heavy import duties and other trade restrictions. If the level of government saving measured as a ratio of GDP grows by 10 percentage points, economic growth accelerates by 1 percentage point on the average.

Lithuania's scores for the first two factors of economic freedom – trade policy and government intervention – are satisfactory. They are 2 points each on the 1-to-5-point scale used by the Heritage Foundation and *The Wall Street Journal*. On the other hand, our economic freedom is being inhibited the most by such law-and-order-related phenomena as entrenched corruption, bureaucratic barriers to business and an insufficiently credible judiciary. So if Lithuania gave priority to solving these problems, i.e. problems which local experts have emphasized on many occasions too, the country would certainly make one step forward on its road to economic prosperity. After all, we are still positioned among „mostly free," not „free" countries, which means that there is plenty room for improvement.

To summarise, we can draw several conclusions. The global experience of economic development raises no doubt that economic freedom is one of key prerequisites for creating economic well-being. The essential and, unfortunately, hardly achievable task is to determine the optimal level of economic freedom. As there are no economies in the world as like as two peas, the optimal scope of government activity is not universal; it does differ across countries. The economic freedom index we are discussing today does not show its optimal level for Lithuania or for any other country, but it is a good indicator of loopholes in government policy and institutional set-up. If we want to facilitate economic progress in our country, we have to find ways to solve those problems first rather than to choose one country as our guiding star and blindly copy its policies.

Thank you for your attention.

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COMMENTARY

Structural funds and agricultural assistance have invariably been used to garner political support for EU membership, but they have never created necessary conditions for economic growth, argues LFMI's President Ugnius Trumpa. The commentary was posted at TCSDaily.com, January 31, 2006.

Robin Hoodwinked

By Ugnius Trumpa, President, LFMI

When it comes to the EU budget, Europe's leaders need to figure out whether they want to play Robin Hood or the Sheriff of Nottingham. That was the dilemma recently invoked by European Commission spokesman Johannes Laitenberg as he criticized the proposal from the UK to cut EU structural funds for new member-states by 10 percent and to reduce the whole EU budget by €20 billion.

Now, as the European Parliament has rejected the draft law on EU budget, it seems politicians have trapped themselves between these two concepts. The authors of this humorous argument did not point out that there was little difference between the deeds of Robin Hood and the sheriff, who both used illegal means to obtain money. What was different was only their perceptions of justice. Therefore the Commission analogy is more worrying than amusing, especially among the new EU member states. If the European Commission is to advocate Robin Hood's ideas of equality and distribution in the future, new member states will find themselves on the way to a new "socialist paradise".

But the new member states responded in unison: the more money, the more solidarity. By doing so, they showed that what they wanted most from EU membership was money, not any other membership-related opportunities and values. It was not only the finance ministers and the prime ministers but also the presidents who joined this harmonious choir opposing the EU budget proposal from the UK. In other words, the tactics of the political “sale” of EU enlargement to the voters have remained unchanged since the founding of the European Union.

Britain’s efforts to expose the major flaws of the EU distribution policy got no response. In adopting the EU budget, no one cared how to reform the Common Agricultural Policy or the allocation of structural funds, how to restore the capacities of the European Union to compete with the US, China and other countries, and how to break the deadlock in the old Europe’s economic development. The UK’s idea to use budget allocation as a lever to draw the member-states’ attention to the EU’s acute problems did not work. Ultimately Britain the reformer gave in, admitting that the economically flawed agricultural policy would not be scrapped.

Paradoxically, the new member states did not even pay heed to the fact that their economic improvement has been due not to government redistribution or largesse, but to free market economics. They took the EU funding bait, and signed up to policies that have stifled the old European economies. Now it’s open to question whether EU member states, hoping for bigger redistribution and more money, will ever be able to jointly undertake groundbreaking reforms at all.

The recent apportioning of money yet unearned confirms that what most of the countries care about is spending money without bothering about where to get it from in the near future. Both structural funds and agricultural assistance have invariably been used to garner political support for EU membership, but they have never created necessary conditions for economic growth. It is equally important that this kind of support has crippled competition, dampening people’s motivations and even international trade. Paradoxically, most of the new member states have discarded such obvious anti-competition policies as direct financial business aid.

Even more paradoxical are the calculations that politicians in the new member states use to boast about how much funding per capita they have managed to garner from the European Union. Such manipulation of figures should frustrate many citizens see none of this money, because it will go to farmers, infrastructure developers, a handful of scientists, and entrepreneurs. At the same time an increase in today’s benefits for the select groups is automatically bolstering the tax burden for all people who will have to finance further EU enlargement and to carry the burden of redistribution.

The nervous and strained talks on the EU budget, which required tremendous efforts on all sides of the negotiating table, recalled Robin Hood and the Sheriff of Nottingham counting their chickens.

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ARTICLE

The following article was published in the Estonian publication “Diplomaatia” Nr.1 (28) January 2006. The author explores the still ongoing political debates regarding the reprivatisation of the Lithuanian oil refinery Mažeikių Nafta and the sore issue of energy dependence.

Energy Dependence, Oil Business, and “Mažeikių Nafta”

By Dr. Remigijus Šimašius, Vice President, LFMI

Energy dependence on Russian energy resources is almost undisputedly seen as a fatal destiny of Lithuania, the rest of the Baltic states, and even entire Europe. Of course, no one can deny the fact that Russia dominates in the gas market, that it is the key player in the oil market, and that it plays a very important role in the electricity market of the Baltic states. It is also obvious that the supply of cheap energy is not to be separated from Kremlin’s political influence and ambitions: the recent Ukrainian–Russian natural gas debate is a perfect illustration.

These evident facts of the Russian energy dominance and political pressure, however, is neither a complete picture of the situation in the energy security nowadays, nor it allows planning a rational strategy which would ensure the interests of energy consumers in Europe, the Baltic states and Lithuania. Let’s us take a look at some latest events from the perspective of Lithuania’s energy market. I will briefly explore one of the main differentiating features of Lithuania’s energy market, as compared to Latvia and Estonia, – the oil refinery giant “Mažeikių Nafta” and the political approach towards it.

Historic overview of policies concerning “Mažeikių Nafta”

The “Mažeikių Nafta” factory has been treated as a very important economic unit, crucial to the Lithuanian economy as a whole, a key element in ensuring energy independence, and at the same time as a threat to energy security of Lithuania. More than a decade ago this approach led Lithuanian politicians to adopt decisions concerning the state support for the construction of the “Butinges nafta” oil import terminal (which, fortunately, was designed both for import and export and today, in fact, is used for oil export only).

The mystification of the factory’s role to the country’s economy also led to probably the most politicized and scandalous privatization. The control of “Mažeikių Nafta” was granted to the US-based company “Williams International” (retaining nearly half of its shares in the hands of the Lithuanian government) instead of selling all shares openly in the market. The famous symbolic phrase “we will not let Ivan to the pipe” expressed by Lithuania’s Minister of Economy in those days became widely known abroad.

It is no surprise that a pro-Western or anti-Russian approach provoked relevant politicized reactions on the Russian side. Today there may be many speculations why "Williams International" failed to ensure a stable oil supply to the factory. However, no one can deny that it was Russia's political ambition in the first place to demonstrate that only a Russian company is able to run the factory successfully. In the end, the Lithuanian "Mažeikių Nafta" had to be sold. Fortunately - to the then star of all Russian oil companies, private "Jukos," and the bright days came to "Mazeikiu nafta" factory.

Lessons from the history

The lesson for Lithuanian politicians to be learned from not so distant history is that wishful thinking leads to nowhere. It was very wishful to think that Western control of the oil refinery would ensure independence from Russia and political influence, as well as sometimes not very acceptable traditions in state dominated Russian oil business. If to be successful commercially, "Mažeikių Nafta" still had to buy oil from Russia ant to transport it through a pipeline. This situation confirms the fact that the problem of dependence cannot be solved by controlling only the factory itself. As Lithuania is not tantamount to the US in size and power, the mechanisms of oil supply simply could not be controlled.

One more lesson is that "Mažeikių Nafta" is not important to Lithuania's energy security at all. Oil products are easily transportable and the market is very competitive. This means that Lithuania may easily import oil products from abroad (even today it does so). On the other hand, it means that "Mazeikiu nafta" has to be very competitive and as a part of it - to keep its advantage of getting oil from Russia. Political influence on the economic activity, as we know, makes this activity less efficient and competitive.

Buy it back and sell again?

It would be to too bold to say that the bright days of "Mažeikių Nafta" are over. However, two political threats to the factory have emerged again. The first threat, which is important but perhaps a more predictable and smaller one, is the decision of the Competition Council of Lithuania concerning the huge fine of 32 million litas for abusing the company's dominant position. The decision does not seem very well-grounded and is still to be disputed in court. But it is certainly a serious headache for the company.

The second threat to "Mažeikių Nafta," which is much more uncertain and less predictable, is related to the change of owners again. It is obvious now that "Jukos" has no other possibility than to sell "Mažeikių Nafta." It wouldn't have been bad it if not the ambitions of the Lithuanian government again. The government has been busy trying to hit at least three targets since the autumn of 2005. Their plan is to buy out "Mažeikių Nafta" from "Jukos" and then to sell it again. The declared targets are (1) to find a new good (politically acceptable?..) owner of "Mazeikiu nafta", (2) to make profit (the plan is to buy the company at cheaper price and then to sell it at a higher one), and (3) to get rid of the much criticized unfavourable conditions of the first privatization agreement (fee for the governance of the company, obligation to cover losses, fixed oil products transportation costs).

The practice, however, does not support the scheme at all, and it was obvious since the very start. The so called unfavourable conditions are not so important any more because the financial obligations of the government are not relevant any more, and fixed transportation costs do not seem to be low any more. To gain profit from this speculatory action is practically impossible, as any potential buyer may offer its bid directly and there is no need to wait for a higher price asked by the Government of Lithuania. This also means that the target of finding a new politically acceptable owner for the company may only be achieved by paying a certain price for it – directly and clearly, or indirectly and latently.

Unfortunately, Lithuania was pushed into discussions about who would be the best possible owner of "Mazeikiu nafta". According to different political statements, the buyer has to have good relations with Russia, but not to be too Russian. The Russian oil giant "Lukoil" even formed a consortium with a US company to meet this criterion. However, the real practice has already almost smashed all of the plans of the government as none of its favourites (TNK-BP and "Lukoil") offered a sufficient price to outbid the Kazachian "KazMunaiGaz" and the Polish "Orlen."

It is not clear what the Lithuanian government is going to do next. As we experienced from the past, it may resort to very unexpected and controversial actions. Hopefully, this time economic arguments will prevail and the government will simply step out of this process. Only by depoliticizing the process itself the Lithuanian government may expect that oil business will be as depoliticized as possible. This lesson has to be taken into account not just in this quite simple case of the oil refinery, but also in much more complicated and more energy-dependence related cases of the nuclear power station and the gas market.

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